Duvvuri Subbarao: Bank resolution framework challenges in the Indian context

Inaugural address by Dr Duvvuri Subbarao, Governor of the Reserve Bank of India, at the International Association of Deposit Insurers (IADI)-Deposit Insurance and Credit Guarantee Corporation (DICGC) International Conference "Role of deposit insurance in bank resolution framework – lessons from the financial crisis", organized as part of DICGC's Golden Jubilee celebrations, Jodhpur, 14 November 2011.

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1. On behalf of the Reserve Bank of India, let me once again extend a hearty welcome to all the delegates to this IADI-DICGC International Conference on the *Role of Deposit Insurance in Bank Resolution Framework – Lessons from the Financial Crisis*. Welcome also to this Sun City of Jodhpur – on the edge of the Thar Desert – a city of forts and palaces, lakes and gardens, and folklore and legend that represents – in its mellifluous blend of tradition and modernity - the best face of India.

DICGC

2. This conference is also part of the golden jubilee celebrations of DICGC which has the distinction of being the second oldest continuing deposit insurance system in the world. Over the past 50 years, the DICGC has been an important part of India's financial sector development; it has grown and evolved, met many challenges and adapted to managing new risks. On the way forward, the DICGC will have to reinvent itself to meet the rising demands of a rapidly growing and structurally transforming economy. To do so, it has to learn from the experience of deposit insurance systems around the world and also from the experience of the global financial crisis. This conference, therefore, is an important learning opportunity for DICGC to move up the value chain in its business.

Lessons from the financial crisis

3. The financial crisis has taken a devastating toll on global growth and welfare. Three years on, the crisis is still with us; it has just shifted geography. In some respects, the 2008 and 2011 crises are similar. Both trace their origins to the mispricing of risk – of private debt in 2008 and public debt in 2011. Both began from deceptively small sources – sub-prime lending in the US in 2008 and government debt in Greece in 2011. The contagion impact in both cases was enormous and destructive. There are striking dissimilarities between 2008 and 2011 as well. In 2008, the crisis revolved around private debt and complex financial products making it difficult to determine where risk lay; in 2011, the crisis is centred around public debt with much greater clarity on where exposure and risk lie. Most importantly, in 2008, governments were a part of the solution; in 2011, governments are the problem. In 2008, we were dealing with unknown unknowns; in 2011, we are dealing with known unknowns.

4. What is striking, and what is important from the view point of this conference, is that no matter where a financial crisis originates, no matter what the causes are and no matter how it evolves, banks become the centre of the crisis. And when banks come under stress, deposit insurance becomes a critical variable in containing the crisis and restoring confidence. To be able to discharge this responsibility efficiently and effectively is then the challenge for the deposit insurance system.

5. The global financial crisis has triggered a re-examination of how financial safety nets function and of the relationships among supervisors, bank insolvency agencies and deposit

insurers. The crisis made us realize that depositors are more risk-sensitive than we had thought. More than ever before, we know that the threat of even small losses can lead to destabilizing runs. This reinforces the case for a truly integrated policy response to shocks, where agencies responsible for supervision, regulation, insolvency and deposit insurance act quickly and in a well-coordinated manner.

6. We also learnt from the crisis that three pillars are required to support a resilient financial system. The first pillar is effective supervision. Important lessons have emerged from the crisis on making supervision stronger and more effective. The second pillar is a robust regulatory framework that integrates a system-wide approach and has built-in buffers to smooth cyclical volatility. And the third pillar, the theme of this conference, is a resolution framework that is quick and effective, and one that creates the proper backstop to efforts at limiting excessive risk.

7. There are varying models around the world on how responsibilities for the above three pillars are allocated across different agencies. The specific regulatory architecture of a country has implications for the role and mandate of the deposit insurance system. In some cases, deposit insurance systems are actively involved in the resolution process, in some cases less actively so, and in some cases not at all. In India, bank resolution rests entirely with the regulators and supervisors, and the DICGC plays only a pay-box role. I thought it appropriate therefore to use the platform provided by this conference to highlight some of the challenges we in India face in bank resolution, and in the process identify the tasks ahead for DICGC.

Indian financial architecture

8. Before going on to discussing the challenges of bank resolution, let me set the context by giving a big picture of the financial system in India.

9. Our financial system comprises commercial banks, cooperative banks, non-banking financial companies, insurance companies, provident and mutual funds, and the newly emerging pension funds, with overall assets close to 140 per cent of GDP. Commercial banks, comprising of 60 per cent of the total financial assets, dominate the financial system. Within commercial banks, public sector banks, with nearly 75 per cent of total assets, have a commanding presence. Commercial banks in India are well-capitalized; system-level capital to risk-weighted assets ratio (CRAR) under the Basel II norms stood at 13.9 per cent as at the end of June 2011, well above the Indian regulatory minimum of 9 per cent.

10. There are certain structural and regulatory features that make India's financial system resilient to stress. Commercial banks are required to hold a significant proportion, currently 24 per cent, of their assets as government paper. The Reserve Bank also mandates a reserve requirement whereby banks are required to hold reserves with the central bank to the extent of the Cash Reserve Ratio (CRR). And importantly, the fact of government ownership of a large segment of commercial banks inspires public confidence. Needless to say, all the insurance implied by the above regulatory and structural factors comes at a cost, and we struggle with balancing the costs and benefits.

11. The Reserve Bank of India has an over-riding role in the financial safety-net architecture in India – it has responsibility for regulation and supervision of banks in addition to its traditional central banking functions. The Reserve Bank has broad resolution powers over commercial banks under the Banking Regulation Act. DICGC, being a wholly owned subsidiary of the Reserve Bank, works in close coordination with the central bank to offer protection to small depositors.

12. A recent and significant development on the financial stability front has been the setting up of the Financial Stability and Development Council (FSDC) under the chairmanship of the Finance Minister with a wide mandate of systemic oversight, regulatory coordination, financial sector development and promotion of financial literacy and financial

inclusion. A sub-committee under the chairmanship of Governor of the Reserve Bank acts as the operational arm of the FSDC. It provides a mechanism for coordination among regulators, and between regulators and the government which, as we realized during this crisis, is critically important, especially during stressed times.

13. Failures of commercial banks in India have been rare. The last time we had a major commercial bank coming under distress was in 2004 and that was resolved by effectively and quickly merging it with another strong public sector bank. Failures among urban co-operative banks are, however, quite common. For banks that fail to meet the minimum prescribed requirements, we institute a regular monitoring mechanism. The weak bank is required to put in place a plan of action indicating targets for critical financial parameters including capital infusion. If weakness in the bank persists with net worth turning negative and there is no credible action plan for a turnaround, it is put under a moratorium. The purpose of imposing a moratorium is to prevent a run on the bank, stop asset stripping and give time to the regulators to identify a suitable strong bank for takeover. The process of merger is put through as expeditiously as possible in a transparent and consultative manner. Importantly, in the Reserve Bank, we have a committee of the Board, the Board for Financial Supervision, which reviews our bank supervisory function and monitors the performance of banks, especially weak banks.

14. The typical resolution methods that we have used in India are assisting the troubled bank in restructuring, or merging it with a strong institution, or closure. The most common method has been assisted or compulsory merger when the weak bank is merged with another bank, usually a public sector bank. There were also cases of voluntary merger where a healthy bank voluntarily took over a weak bank. Apart from making payouts to banks that are put under liquidation, DICGC assists in mergers by meeting the shortfalls in depositors' claims up to the coverage limit when the acquiring bank is unable to meet this liability. In case of smaller urban cooperative banks, the general approach has been to liquidate the bank with reimbursement made to depositors.

Bank resolution framework and deposit insurance

15. The financial crisis has underscored the importance of rapid resolution to arrest contagion and restore stability. We need a resolution process where banks can be wound down in an orderly fashion, removing the unsafe or unsound elements but preserving the vital financial activities. International financial standard setting bodies like the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) have emphasized the need for national authorities to have appropriate tools to deal with all types of financial institutions in difficulty so as to help maintain financial stability, minimize systemic risk, protect consumers, limit moral hazard and promote market efficiency. It is, of course, still "work in progress".

16. Where do we in India stand on this? Even as we have been able to resolve problem banks so far, it is not clear that our resolution framework has been put to severe test. There are several questions. Is our resolution process quick and effective? What are the fundamental resolution tools that we must have to confront not only small failures but the possible failures of medium and large banks? What constraints would we face in preserving value if our financial firms become globalized or systemically important? And importantly, for DICGC, what is the optimal role for the deposit insurer in the resolution regime? Should we consider an alternative distribution of insolvency responsibilities among the safety net players?

17. Addressing these questions will require some fundamental changes in our legal and regulatory framework. I cannot, and do not, intend to attempt an action plan in this regard. What I will do, instead, is to present some specific issues and constraints in the bank resolution framework of India.

I. Appropriate legal framework

18. The first challenge is developing a comprehensive legal framework for resolution that covers all the different types of financial institutions. Currently, the relevant provisions governing issues such as control of management, acquisition of the financial institution, suspension of business and winding up, are all spread over different laws and regulations. Moreover, different types of banks are covered by different statutes. For example, banks which are constituted as companies are governed by the Banking Regulation Act, 1949 and the Companies Act, 1956 [private sector banks and foreign bank offices]. The resolution regimes for public sector banks, viz., State Bank of India, its subsidiaries, nationalised banks and regional rural banks, which have been created by separate acts of Parliament, are contained in their respective statutes. In the case of co-operative banks, the registrars of co-operatives at the central or state-level are responsible for oversight of some aspects of their functioning, including their winding-up and restructuring. Deposit insurance is covered separately in the DICGC Act, but is not integrated with banking laws. All in all, the legal framework governing bank resolution is spread all over, making the framework complex, confusing and oftentimes non-transparent.

19. One big issue that needs to be addressed is whether the court-driven procedure as followed in India for bank resolution can be made faster. The resolution process can be further delayed if the shareholders of a bank challenge the authority of the regulator to resolve the bank. In India, an enterprise proposing to enter into a combination via a merger or an amalgamation is required to notify the Competition Commission, and the Commission has been allowed up to 210 days to decide on it before the default clause kicks in. This further complicates the resolution of banks through mergers and the uncertainty can be potentially destabilizing. We have made a proposal to the Government to exempt bank mergers from this provision.

20. We in India need to watch for “best practice” regarding the time frame for resolving a bank. The process has to be quick enough so that creditors of banks, especially small depositors, do not suffer undue losses and delays; maximum value is derived from the failed or failing institution; and the shareholders bear the brunt of the loss. We also know that markets penalize delay in decision making and uncertainty over the future of a failing institution. This conference should deliberate on what is a reasonable timeframe for resolution for different types of institutions that harmonizes various competing interests.

II. Extended role for deposit insurer

21. The second issue that we need to address is where the “resolution authority” should lie – in particular, whether DICGC should have a more proactive role in the supervisory framework to aid early identification of bank failures and their effective resolution. Over the last fifty years, DICGC has done a good job in performing its “pay box” role. But in making quick payments to depositors, it is handicapped by inadequate information sharing arrangements regarding depositors. In India failures of commercial banks have been rare, and the beneficiaries of the deposit insurance system have mainly been the urban co-operative banks. While the regulatory and supervisory framework for urban co-operative banks has over time been brought on par with that for commercial banks, the resolution mechanism for these banks is not fully in the hands of the Reserve Bank; we share authority with the central or state governments concerned. Because of this dual control, there are delays in resolution of this segment of banks right from the appointment of liquidators, gathering of information about depositors (which may not always be available in electronic form), depositor payouts and recovery of assets.

22. Globally, deposit insurance systems, with broad mandates, are assuming a significant role in the resolution of troubled banks. With access to information on risk assessment of banks, they are able to take prompt corrective action. This arrangement gives the insurer greater ability to address costs as compared to pure pay-box systems.

23. Deposit insurers adopt a “least cost” approach for resolving a failed institution. This involves closer cooperation and coordination of appropriate actions taken by safety-net participants, *viz*., the government, regulatory bodies, the central bank and the deposit insurer. Experience shows that deposit insurers with sufficiently broad mandates, with adequate powers, operational independence, and assured sources of contingency funding, have been more effective in building and maintaining public confidence and dealing with financial crises.

24. Some countries have undertaken a review of their deposit insurance systems and resolution frameworks and instituted important changes. In India, we need to examine the benefits of granting an extended mandate to the DICGC in resolution of failing banks from the point of view of faster settlement to depositors, lower costs and speed of resolution with associated benefits for the stability of the financial system. A solution to the problem lies in putting in place a clearly defined solvency regime and a properly designed resolution process. The Financial Sector Legislative Reforms Commission appointed by the Government is comprehensively reviewing all the laws that apply to the financial sector with the aim of making them supportive of an expanding and modernizing financial sector. It is expected that the Commission will recommend a fundamental restructuring of some laws so as to make the legal framework simple, transparent and efficient. From the Reserve Bank, we will present our view before the Commission, and streamlining of laws relating to bank resolution and reviewing the mandate of the DICGC will be part of our presentation.

III. Cross-subsidization

25. A third challenge that we have been facing arises from the heterogeneity of banks being covered under deposit insurance. In particular, we have commercial banks and cooperative banks whose laws and structures are different and their failure rates, as I said earlier, are also different. But they are all covered by a uniform premium for insurance under the DICGC. This inevitably leads to cross-subsidization of cooperative banks by commercial banks. Illustratively, over five years, on an average, commercial banks contributed 92 per cent of the premium received by DICGC while the entire amount of payout was to co-operative banks, which account for only 14 per cent of the deposits insured by DICGC.

26. This cross-subsidization, or charging premium at a uniform rate from all categories of banks, obviously raises a moral hazard. One option for reducing cross-subsidy is to charge a risk-based premium, but we are not sanguine that this is necessarily optimal in India. There needs to be a clearer assessment of the tradeoff between minimizing the moral hazard and placing the additional burden of a higher premium on banks that are already weak and yet serve the very important objective of financial inclusion. Another concern is that imposition of risk based premiums could have a market impact, with stock prices of already weak banks negatively affected by the burden of higher premiums. On the other hand, cross-subsidization can, in fact, be justified by viewing higher premiums on larger banks as a surcharge for their larger externalities on the rest of the system. I hope some of these cross-subsidization and moral hazard issues will figure in the deliberations of this conference.

IV. Adequacy of deposit insurance fund

27. The fourth challenge I want to raise relates to estimating the adequacy of the deposit insurance fund. Public confidence in deposit insurance will be determined largely by whether the public believes that the deposit fund is large enough to meet its commitments. DICGC maintains an ex-ante fund that is funded by the premium collected from insured banks and income generated from investment of funds. For maintaining depositor confidence, the fund is required to be robust enough to meet claims arising out of routine failure of banks under normal situations. Going by the past record of failures, the fund maintained by DICGC appears adequate. But it is not clear that the fund will be able to meet claims arising from the putative failure of a couple of small or medium size commercial

banks. Admittedly, no deposit insurer can maintain enough liquid funds to face a widespread financial crisis. In an extraordinary situation of systemic failure of banks, it is imperative that the deposit insurer is armed with unlimited and quick access to funds from the central bank and/or the government so that financial stability is not jeopardized. As we all know, it was arrangements such as this that played a crucial role in containing panic among depositors during the 2008 crisis.

V. Cross-border bank resolution

28. Another challenging area not only for us but also at the global level is cross-border bank resolution. The main problem is differences in laws and regulatory frameworks across countries which makes resolution difficult, inefficient and costly. There is clearly a strong case for moving towards a more harmonized legal and regulatory framework.

29. In India, the presence of cross border banks is relatively small. But as the world economy recovers and global trade and financial transactions grow, India will increasingly be exposed to cross border risks. Now is the time to identify steps to make failure resolution both fast and effective regardless of its provenance. We will need to strengthen relations with foreign supervisory authorities, intensify information sharing, and consider ways to develop a consensus on options for resolving a failing global institution.

30. A connected issue in this context, one that has been engaging our attention for the past few years, is the appropriate framework for operations of foreign banks in India. In particular, we are debating whether we should require compulsory local incorporation of foreign banks. The organizational structure for cross-border banking groups differs across the world and reflects the diversity of their business models and the varying stages of financial development of different countries. Both the branch and subsidiary models have merits as well as limitations. The predominant view globally is that under a branch mode, it may be difficult to determine the assets that would be available in the event of the failure of the foreign bank to satisfy local creditors' claims and the local liabilities that can be attributed to the branch. The subsidiary framework provides greater regulatory control and comfort to the host jurisdictions, apart from easing the resolution process. In crisis situations, the distinction between the branch and the rest of the bank, and the legal location of assets and liabilities can be really important. The Reserve Bank will be bringing out guidelines for the presence of foreign banks in India based on the discussion paper that was released in January this year.

VI. Resolution framework for SIFIs

31. The last challenge I want to raise is regarding regulation of systemically important financial institutions (SIFIs). Oversight and regulation of SIFIs is currently high on the international agenda, especially as they have a large presence in many countries and also encompass a huge non-banking sector. The treatment of SIFIs requires a host of skills and knowledge that all countries are struggling to understand. There is a debate on the appropriateness of "systemic surcharges" that require SIFIs to hold additional capital. While such higher capital will impose additional costs on the firms, the benefits by way of stronger balance sheets that are able to withstand sharp financial shocks are expected to outweigh the costs.

32. Equally importantly, we need to develop an effective resolution regime for non-bank financial institutions. Setting new risk management and supervisory standards for large and complex institutions is a huge task; their implementation will be even more demanding. So far, the differences in the regulatory and legal treatment of banks and non-banks have been understandable as their activities were concentrated in different markets. The emergence of large complex financial institutions and groups that straddle both banking and non-banking space makes the integration of such supervisory and resolution frameworks imperative. This

effort will require considerable time, resources, expertise and approach that incorporates a system-wide analysis of risks.

33. Many Indian banks have grown and expanded to become “financial conglomerates” offering different financial products in different markets. These can be construed as “domestic SIFIs”. This poses two challenges from a regulatory perspective – absence of adequate legal framework and limited inter-regulatory co-operation framework.

34. First, enhancing the efficiency of resolution within the existing legal and regulatory framework is one of the key responsibilities of the newly created FSDC. An important task will be drawing up resolution plans that explicitly take into consideration information on inter-linkages among institutions. In addition, we also need to think in terms of a mechanism similar to supervisory colleges for global SIFIs.

35. Second, the supervision of such conglomerates must start with an understanding of banks’ business models and risk profiles. The Reserve Bank has carved out a “financial conglomerates monitoring division” to institute a system of close and continuous supervision of large and systemically important banking groups. There are currently twelve institutions falling under this category, accounting for 53 per cent of total assets of the banking sector. We have also begun to apply a forward-looking approach by carrying out stress tests under various scenarios as part of our half-yearly Financial Stability Reports. The FSDC sub-committee is currently engaged in developing an institutional framework for inter-regulatory coordination for monitoring large financial conglomerates.

Conclusion

36. The global financial crisis, as someone said, is too important to waste. We have, of course, learnt a lot of lessons. We now know that financial markets do not self-correct and that the costs of financial destabilization can be huge. We also know that the signals of instability can be difficult to see in real time and we have therefore to be extra watchful. We are also more sensitive to the need for putting in place quick, effective and transparent resolution systems so that contagion can be arrested.

37. Another big lesson of the crisis has been that even as each of us has to learn from the sum total of our collective experience, the solutions that we adopt have to be contextual and tailored to country circumstances. This applies to the whole gamut of regulation and supervision of financial systems including the operation of deposit insurance systems. I hope this conference will take us closer to “thinking global and acting local”. I wish your deliberations all success.